The Federal Reserve Board

Minutes of the Federal Open Market Committee

March 20-21, 2007

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, March 20, 2007 at 2:30 p.m., and continued on Wednesday, March 21, 2007 at 9:00 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Mr. Hoenig
Mr. Kohn
Mr. Kroszner
Ms. Minehan
Mr. Mishkin
Mr. Moskow
Mr. Poole
Mr. Warsh

Ms. Cumming, Mr. Fisher, Ms. Pianalto, and Messrs. Plosser and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Lacker and Lockhart, and Ms. Yellen, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Mr. Alvarez, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Evans, Fuhrer, Kamin, Madigan, Rasche, Slifman, and Wilcox, Associate Economists

Mr. Dudley, Manager, System Open Market Account

Messrs. Clouse and English,[1] Associate Directors, Division of Monetary Affairs, Board of Governors

Mr. Struckmeyer, Associate Director, Division of Research and Statistics, Board of Governors

Mr. Reifschneider, Deputy Associate Director, Division of Research and Statistics, Board of Governors

Messrs. Dale[2] and Oliner, Senior Advisers, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

Mr. Hambley,[2] Assistant to the Board, Office of Board Members, Board of Governors

Mr. Meyer, Visiting Reserve Bank Officer, Division of Monetary Affairs, Board of Governors

Mr. Small,[1] Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Kiley[2] and Ms. Kole,[2] Section Chiefs, Divisions of International Finance and Research and Statistics, respectively, Board of Governors

Mr. Doyle,[2] Ms. Mauskopf,[2] and Mr. Wood,[2] Senior Economists, Divisions of International Finance, Research and Statistics, and International Finance, respectively, Board of Governors

Ms. Roush, Economist, Division of Monetary Affairs, Board of Governors

Mr. Gross, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors

Mr. Rosenblum, Executive Vice President, Federal Reserve Bank of Dallas

Mr. Hakkio, Ms. Mester, Messrs. Rolnick, Rudebusch, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Kansas City, Philadelphia, Minneapolis, San Francisco, and Cleveland, respectively

Messrs. Cunningham and Hilton, Vice Presidents, Federal Reserve Banks of Atlanta and New York, respectively

Ms. Sbordone, Research Officer, Federal Reserve Bank of New York

Mr. Hetzel, Senior Economist, Federal Reserve Bank of Richmond

1. Attended Wednesday's session. Return to text

2. Attended portion of the meeting relating to the discussion of communications issues. Return to text

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The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at the March meeting indicated that the economy appeared to be expanding at a modest pace in the first quarter. Declines in residential construction activity continued to weigh on overall activity, and business investment had softened considerably over the preceding several months, especially in equipment used in the construction and motor vehicle industries. However, consumer spending had increased appreciably in the early part of the year, and labor demand continued to expand, albeit at a somewhat slower pace than last year. Meanwhile, the twelve-month increase in core consumer prices remained elevated relative to its pace one year earlier.

Employment gains moderated in early 2007. In February, employment in the construction industry contracted considerably, in part because of severe winter storms; manufacturing employment also declined, but hiring in service-producing sectors remained solid. A decline in the average workweek led to a contraction in aggregate hours. At the same time, the unemployment rate edged down from 4.6 percent in January to 4.5 percent in February.

Industrial production rose strongly in February and was revised up for both December and January. In February, production was boosted by a rebound in motor vehicle assemblies and by a temporary surge in output at utilities that reflected a swing from unseasonably warm temperatures in January to colder weather in February. Production rose at a solid pace in all major high-tech categories. Output of materials and defense and space equipment expanded as well. In contrast, production of consumer goods and business equipment changed little, while output of construction supplies declined.

Real consumer spending appeared on track to rise at a robust pace in the first quarter, buoyed in part by a weather-related surge in spending on energy services and by a jump in sales of light motor vehicles. Outside of these areas, however, real consumer spending moderated. The determinants of household spending were mixed. Disposable personal income was estimated to have risen sharply in January, but the increase was partly the result of special factors, such as pay raises for federal and military personnel and cost-of-living adjustments to Social Security payments. Meanwhile, readings on consumer sentiment, which had been favorable in recent months, edged down in early March. The boost to consumer spending from earlier gains in wealth was likely being muted by the lagged effects of the upward trend in borrowing costs. In addition, recent declines in equity prices and slowing house price appreciation pointed to a modest reduction in households' wealth-to-income ratio in the first quarter.

Housing starts declined in January, extending the downward trend that had been in place since early 2006, but bounced back in February. However, adjusted permit issuance in the single-family sector continued to step down, suggesting that builders were still slowing the pace of new construction to work off elevated inventories. The inventory of new homes for sale remained high, although cuts in residential construction in the last few months had reduced the number of unsold homes. As at the time of the January meeting, available data suggested that housing demand was stabilizing. Sales of both new and existing single-family homes in recent months were, on balance, in line with the pace seen since mid-2006. However, a tightening of standards for subprime borrowers in recent weeks seemed likely to restrain home sales. House price appreciation had slowed further, with some measures showing outright declines in home values.

Business fixed investment had been sluggish in recent months. Real spending on equipment and software fell in the fourth quarter, and nominal orders for and shipments of nondefense capital goods excluding aircraft posted widespread declines in January, with transportation equipment showing a very large drop. Business purchases of light vehicles remained low, and new orders for and deliveries of medium and heavy trucks plunged in the last few months after a surge in 2006. Investment in goods and services other than transportation and high-tech equipment softened more than fundamentals had suggested. Declines in spending for capital equipment that is used heavily in the construction and motor vehicle industries accounted for an outsized share of the drop in orders and shipments at manufacturers outside high-tech and transportation in January. Investment in categories such as industrial equipment; electromedical, measuring, and controlling devices; and other electrical equipment also softened. In contrast, computer imports surged in January, suggesting rising domestic purchases, and computer sales appeared to have picked up in February. The ample cash reserves held by firms and ongoing reductions in the user cost of high-tech capital goods remained supportive of investment going forward.

Businesses accumulated inventories of items other than motor vehicles at a slower pace in January than in the previous two quarters. Even so, the ratio of inventories to sales for manufacturing and trade excluding motor vehicles remained elevated. In addition, purchasing managers at manufacturing firms, on net, continued to view their customers' inventory levels as too high.

The U.S. international trade deficit narrowed considerably in the fourth quarter. Exports rose, partly reflecting a robust increase in deliveries of civilian aircraft to foreign buyers, while imports were pushed down by a fall in the volume and price of imported oil. In January, the trade deficit was little changed.

Economic activity in the advanced foreign economies accelerated in the fourth quarter. In Japan, private consumption rebounded strongly, and private investment and net exports continued to boost growth. The pace of economic expansion in the euro area picked up as investment and exports rose. Growth in the United Kingdom firmed because of brisk investment spending and a rebound in consumption growth. In contrast, output in Canada decelerated in the fourth quarter as inventory accumulation turned down sharply. Recent data for the emerging-market economies pointed to continued strength in activity, although there were signs that growth was moderating in some countries. Growth remained solid in China but decelerated in several other Asian economies and Mexico.

In January, the overall PCE price index rose moderately as a decline in energy prices helped to offset a jump in food prices. Meanwhile, the PCE price index excluding food and energy rose at a faster pace than in the previous two months. Increases in consumer energy prices and higher prices for fruits and vegetables in February reflected a period of unusually cold weather and contributed to an acceleration in that month's CPI. Excluding food and energy, core CPI inflation slowed slightly in February but remained elevated. In recent months, prices had risen across a broad range of core goods. On a twelve-month-change basis, core CPI inflation in February was considerably above its pace a year earlier, largely because of a sharp acceleration in shelter rents over the past year. Average hourly earnings also rose at a noticeably faster pace during the year ending in February than during the preceding twelve-month period. Surveys indicated that households' expectations of inflation over the next year were little changed in February while households' and professional forecasters' longer-term inflation expectations edged lower.

At its January meeting, the Federal Open Market Committee maintained its target for the federal funds rate at 5-1/4 percent. The Committee's accompanying statement noted that recent indicators had suggested somewhat firmer economic growth and that some tentative signs of stabilization had appeared in the housing market. Overall, the economy seemed likely to expand at a moderate pace over coming quarters. Readings on core inflation had improved in recent months, and inflation pressures seemed likely to moderate over time, but the high level of resource utilization had the potential to sustain inflation pressures. The Committee judged that some inflation risks remained. The extent and timing of any additional firming that might be needed to address these risks would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

The FOMC's decision at its January meeting was in accord with market expectations, but the accompanying statement reportedly was read as a sign that the Committee was more sanguine about inflation prospects than in December, and the expected path for monetary policy beyond 2007 edged lower. Policy expectations declined a bit more in the wake of the Chairman's semiannual monetary policy testimony, which apparently reinforced investors' beliefs that the FOMC anticipated gradually diminishing inflation pressures. Economic data releases were somewhat weaker than expected on balance over the first few weeks of the intermeeting period, and policy expectations moved appreciably lower on net by mid-February. Financial market volatility increased sharply in the second half of the intermeeting period amid an apparent pullback from risk-taking that was reportedly spurred by mixed news on domestic economic activity, mounting concerns about the subprime mortgage sector, and significant declines in foreign equity prices. On net over the intermeeting period, investors tilted their anticipated path for monetary policy beyond mid-2007 down substantially, and yields on two- and ten-year nominal Treasury securities fell 30 to 40 basis points. Yields on inflation-indexed Treasury securities generally declined somewhat less than their nominal counterparts, leaving inflation compensation slightly lower across the term structure. Broad stock price indexes dropped several percent on net over the period. Yields on investment-grade corporate bonds fell about in line with those on Treasury securities of comparable maturity. In contrast, yields on speculative-grade bonds declined only modestly, leaving risk spreads noticeably wider, albeit still narrow by historical standards.

Domestic nonfinancial sector debt appeared to be continuing to rise at a relatively brisk rate in the first quarter. Despite the recent volatility in financial markets, funding in the bond and syndicated loan markets appeared to remain readily available. However, borrowing by nonfinancial corporations was estimated to be moderating somewhat in the first quarter, with a step-down in bond issuance associated with merger and acquisition activity. Indicators pointed to a continuing deceleration in house prices this quarter, and home mortgage borrowing probably continued to slow. M2 increased more moderately in February than at the end of 2006 as the expansion of liquid deposits slowed from its outsized fourth-quarter rate.

In its forecast prepared for this meeting, the staff marked down the projected increase in real GDP in the first quarter in response to weaker-than-expected incoming data on business equipment spending and federal defense purchases. The recent increase in oil prices and decline in equity prices, along with increased strains in the subprime mortgage sector, were expected to exert some drag on real activity over the remainder of the year. Even so, real GDP growth was expected to pick up to a rate a little below that of the economy's long-run potential for the remainder of 2007, as declines in residential construction activity lessened, and to remain at a similar rate in 2008. The increase in energy prices over the intermeeting period led the staff to revise up its forecast for headline PCE inflation during the first half of this year, but the staff continued to expect that core PCE inflation would edge down over the remainder of this year and next.

In their discussion of the economic situation and outlook, meeting participants agreed that, while recent economic data had been mixed, the economy was likely to expand at a moderate pace in coming quarters. Although the housing sector adjustment continued, accumulating data suggested that the demand for homes was leveling out. Business fixed investment had been soft in recent months, but financing conditions and other fundamentals remained favorable for a pickup in capital spending. Moreover, continuing gains in personal income could be expected to support growth in consumer spending. Thus economic growth likely would increase in coming quarters to a pace close to or modestly below the economy's trend growth rate. However, additional evidence of sluggish business investment and recent developments in the subprime mortgage market suggested that the downside risks relative to the expectation of moderate growth had increased in the weeks since the January FOMC meeting. At the same time, the prevailing level of inflation remained uncomfortably high, and the latest information cast some doubt on whether core inflation was on the expected downward path. Most participants continued to expect that core inflation would slow gradually, but the recent readings on inflation and productivity growth, along with higher energy prices, had increased the odds that inflation would fail to moderate as expected; that risk remained the Committee's predominant concern.

Participants reported signs of stabilization in housing demand in most regions of the country. At the national level, sales of new and existing homes, while fluctuating in recent months, did not display declining trends. The inventory of new homes for sale reportedly had fallen further from its recently elevated level. Participants noted, however, that such inventories likely would need to be worked down appreciably more before growth in housing construction would resume. The increase in delinquencies on subprime adjustable-rate mortgage loans and the ensuing increase in interest rates and tightening of credit standards in the subprime mortgage market likely would constrain home purchases by some borrowers, perhaps retarding the recovery in the housing sector. However, there was no sign of spillovers from the subprime market to the overall mortgage market; indeed, interest rates on prime mortgage loans had declined somewhat in recent weeks, along with yields on U.S. Treasury securities. Moreover, home-buying attitudes had improved and continuing job growth could be expected to support home sales.

Business fixed investment spending had been surprisingly weak of late, given strong corporate balance sheets, high profitability, anticipated growth in sales, and favorable financial conditions. Participants continued to expect these fundamentals to support a firming of investment spending going forward, and they saw no indication that recent market volatility had prompted a reduction in the availability of financing for business investment. Also, declining office vacancy rates in some areas were spurring gains in nonresidential construction activity, and further advances in commercial construction were seen as likely. Energy prices were high enough to encourage continued investment in alternative fuels. However, the relatively slow pace of investment in recent months might be signaling that business executives had become less certain about the outlook, and perhaps that they expected quite modest gains in sales. Participants agreed that the possibility of persistently sluggish investment spending was an important downside risk to the outlook for economic growth.

Growth in consumer spending would likely continue to be supported by gains in employment and incomes. Meeting participants noted that weakness in the housing market had not spilled over to aggregate consumption--though the flattening out in house prices likely would contribute to an increase in the personal saving rate--and turmoil in the subprime mortgage market did not appear to be generating any diminution in the availability of other types of household credit. The recent increase in oil prices and the reduction in household net worth resulting from the small net declines in equity prices during the intermeeting period warranted a modest downward adjustment in projected growth of consumer spending. Even so, the possibility that the personal saving rate would fail to rise as projected in the staff forecast remained an upside risk to the outlook.

Growth in federal as well as state and local government spending probably would remain a source of stimulus to the economy. Moreover, continued expansion in domestic demand in our major trading partners could be expected to sustain solid growth in U.S. exports.

Many participants again reported softness in manufacturing, primarily but not exclusively in industries related to housing or automobiles. However, a number of firms outside of the housing sector--including auto companies--appeared to have made progress in reducing inventories to more comfortable levels, and contacts in the industrial sector were generally optimistic about future growth. Such attitudes were consistent with national and regional surveys that pointed to a rebound in manufacturing activity later this year.

Anecdotal and statistical evidence suggested that labor markets remained relatively tight. Business contacts continued to report shortages of skilled workers in technical and professional fields, with significant wage pressures in some occupations, as well as a scarcity of less skilled and unskilled workers in some areas of the country. So far, aggregate measures of labor compensation were showing only moderate increases, but, looking ahead, the possibility that labor costs might rise more rapidly was seen as an upside risk to inflation. It was noted, however, that increases in compensation that exceeded productivity gains might be absorbed to some extent by a narrowing of firms' high profit margins. Participants expected that productivity growth would pick up as firms slowed hiring to a pace more in line with output growth but acknowledged that the improvement might be limited, particularly if business investment spending were to remain soft.

Most participants continued to expect a gradual decline in core inflation over the next year or two, fostered by stable inflation expectations, a likely deceleration in shelter costs, and a slight easing of pressures on resources. Nonetheless, all meeting participants expressed concern about the risks to this outlook. The latest readings on core inflation were higher than expected, and it was difficult to discern whether the apparent downward trend in core inflation during the past few quarters was continuing. Also, the recent increases in prices for energy and some non-energy imports likely would boost overall inflation in the near term and might put upward pressure on prices of some core goods and services. Moreover, rates of resource utilization that were near the high end of historical experience suggested a possibility that inflation pressures could build. Participants agreed that risks around the expected and desired path of a gradual decline in core inflation remained mainly to the upside; some noted that upside risks to inflation appeared to have increased slightly in recent months.

In the Committee's discussion of monetary policy for the period between its March and May meetings, all members favored keeping the target federal funds rate at 5-1/4 percent. Recent developments were seen as supporting the Committee's view that maintaining the current target was likely to foster moderate economic growth and to further the gradual reduction of core inflation from its elevated level. Nonetheless, the combination of generally weaker-than-expected economic indicators and uncomfortably high readings on inflation suggested increased downside risks to economic growth and greater uncertainty that the expected gradual decline in core inflation would materialize.

In light of the recent economic data and anecdotal information, the Committee agreed that the statement to be released after the meeting should note that economic indicators had been mixed, that the adjustment in the housing market was ongoing, and that the economy seemed likely to expand at a moderate pace over coming quarters. Members agreed the statement also should indicate that inflation pressures seemed likely to moderate over time, but that recent readings on core inflation had been somewhat elevated and the high level of resource utilization had the potential to sustain inflation pressures. A persistence of inflation at recent rates could eventually have adverse consequences for economic performance. All members agreed the statement should indicate that the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. The Committee agreed that further policy firming might prove necessary to foster lower inflation, but in light of the increased uncertainty about the outlook for both growth and inflation, the Committee also agreed that the statement should no longer cite only the possibility of further firming. Instead, the statement should indicate that future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

"The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5-1/4 percent."

The vote encompassed approval of the text below for inclusion in the statement to be released at 2:15 p.m.:

"In these circumstances, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information."

Votes for this action: Messrs. Bernanke, Geithner, Hoenig, Kohn, and Kroszner, Ms. Minehan, Messrs. Mishkin, Moskow, Poole, and Warsh.

Votes against this action: None.

The Committee then returned to the topic of improving policy communications. Participants expressed a range of views on the possible advantages and disadvantages of specifying a numerical price objective for monetary policy and on technical aspects of a quantification. Participants emphasized that any such move would need to be consistent with the Committee's statutory objectives for promoting maximum employment as well as price stability. The Committee made no decisions on this issue. Participants also discussed the communications role of the economic projections that are made periodically by the members of the Board of Governors and the Reserve Bank presidents. A number of substantive and practical issues would still need to be evaluated before the Committee could make decisions about an enhanced role for projections in explaining policy. The Committee planned to continue its review of communication issues at the FOMC meeting in June 2007.

It was agreed that the next meeting of the Committee would be held on Wednesday, May 9, 2007.
The meeting adjourned at 1:30 p.m.

Notation Vote
By notation vote completed on February 20, 2007, the Committee unanimously approved the minutes of the FOMC meeting held on January 30-31, 2007.

Vincent R. Reinhart
Secretary

Return to top

FOMC
